NOTES

PROFIT ON THE SALE OF CAPITAL AS INCOME UNDER THE SIXTEENTH AMENDMENT.—In holding stock dividends not income within the meaning of the Sixteenth Amendment, the Supreme Court declared through Mr. Justice Pitney: "It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in so doing realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit."[1] Notwithstanding this clear declaration that profit from the sale of capital is income, Judge Thomas of the federal court for the District of Connecticut has held the contrary in *Brewster* v. *Walsh* (D. C., Conn.) 268 Fed. 207. "There is no income from the sale of investments," he tells us. He appears to be convinced that the Supreme Court is directly opposed to its most recent utterance. He thinks that, in view of earlier declarations, Mr. Justice Pitney's statement "must mean that the profit derived from such transactions, if it is income, applies in the case of a trader and not in the case of an individual who merely changes his investments." This neglects the fact that the objector in the Stock Dividend Case was, to all appearances, not a trader but a lady investor. It neglects the caution taken by the Supreme Court to include profit from the sale of capital in its definition of the meaning of "incomes" in the Sixteenth Amendment. After saying that "Congress cannot by any definition it may adopt conclude the matter," the proper definition is put as follows: "'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* Case, 247 U. S. 183."[2] Though the *Doyle* Case involved the Corporation Excise of 1909, and another case,[3] as Judge Thomas points out, had declared that what Congress meant by "Income" in that Act need not be restricted to technical income that would be taxable as such, this loses all significance after the definition of income in the *Doyle* Case is explicitly incorporated into the definition of income under the Sixteenth Amendment. Even if this definition and the other declarations in the Stock Dividend Decision were to be taken as technically *obiter,* they appear to be conclusive evidence of what the Supreme Court now thinks about the matter.

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[1] *Eisner* v. *Macomber* (1920) 252 U. S. 189, 212, 40 Sup. Ct. 189.

[2] 252 U. S. 189, 207, 40 Sup. Ct. 189. The case referred to is *Doyle* v. *Mitchell Brothers Co.* (1918) 247 U. S. 179 38 Sup. Ct. 467. The case involved income from the sale of timber. The stumpage value had not enhanced since the effective date of the Act of 1909, and it was held that the stumpage value as of that date could be deducted from the gross proceeds of the lumber. But the court declined to value the stumpage by subtracting the cost of lumbering from the price received for the product. Though in this case the gain taxed was due to the process of conversion, in *Hays* v. *Gauley Mountain Coal Co.* (1918) 247 U. S. 189, 38 Sup Ct. 470, and *United States* v. *Cleveland, C. C. & St. L. Ry.* (1918) 247 U. S. 195, 38 Sup. Ct. 472, decided the same day, the doctrine of the *Doyle* Case was applied to hold taxable the gain derived from the sale of shares of stock, in so far as the gain had accrued since December 31, 1908, and to hold not taxable the gain accrued before. The exclusion of the prior gain was based on the assumed intent of Congress to tax only gains accruing and realized after the effective date of the Act.

[3] *Stratton's Independence* v. *Howbert* (1913) 231 U. S. 399, 416, 34 Sup. Ct. 136. But the objection discountenanced in this case under the Act of 1909 was later discountenanced under the Act of 1913 in *Stanton* v. *Baltic Mining Co.* (1916) 240 U. S. 103, 36 Sup. Ct. 278.

For his contrary conclusion Judge Thomas goes back to *Gray* v. *Darlington*[4] which held a profit on bonds bought in 1865 and sold in 1869 not income for the year 1869 under the Income Tax Act of 1867. He affirms that "the meaning of the word 'incomes' in the Sixteenth Amendment is no broader than its meaning in the Act of 1867." Yet in interpreting the Act of 1867, Mr. Justice Field had said that it "looks, with some exceptions, for subjects of taxation only to annual gains, profits, and income."[5] Among the exceptions noted is the gain from the sale of realty purchased within the two previous years. Obviously an interpretation of income in one section of the Act of 1867, which recognizes that other sections have a different meaning, is no criterion of the meaning of income in the Sixteenth Amendment, entitled to the slightest consideration as against a contrary explicit interpretation of that Amendment. All doubt whatever on the point would be foreclosed but for the fact that Mr. Justice McKenna in *Lynch* v. *Turrish* quoted with approval Mr. Justice Field's statements in *Gray* v. *Darlington*[7] and remarked that the "case has not since been questioned or modified."[8] He cannot mean by this that the case or its doctrine has been uniformly followed in the interpretation of later statutes, for this is negatived by the cases under the Corporation Excise of 1909.[9] Mr. Justice McKenna adduced *Gray* v. *Darlington*[10] to dismiss the government's contention that gain accrued before the Amendment and the statute is income afterwards if realized afterwards. He was not considering a case of gain accruing subsequent to the Amendment, like the one before Judge Thomas. Though Mr. Justice Field's language, which Mr. Justice McKenna approves, is somewhat ambiguous, it quite possibly means no more than that unrealized gain is not income and that a section of a statute which looks only to annual gains excludes gain accruing prior to the year of its realization. Even if Mr. Justice McKenna agrees with Judge Thomas, it is certain that Mr. Justice Pitney does not, and that the four dissenting judges in the Stock Dividend Case do not. Four and one make five; and five is more than half of nine. The importance of Mr. Justice Pitney's very clear statement is enhanced by the probability that it was designed to assure prospective critics that the Stock Dividend Decision would not render stock dividends eternally immune from the income tax. It is incredible that the Supreme Court will later go back on this assurance.

Though the law is "nothing more pretentious" than "the prophecies of what courts will do in fact,"[11] a genteel tradition permits legal discussion not confined to adventures in probing judicial psychology. One may therefore hope for pardon for a brief excursion into the mixture of metaphor, analogy and personal preference commonly called principle. Profits from the sale of capital satisfy the only two requisites of income thus far prescribed by the Supreme Court as part of the Sixteenth Amendment. These are gain and its realization. We may grant with Judge Thomas that "before the sale all the plaintiff possessed was capital without any part of it constituting income." This is because the second requisite of legal income was not yet added to the first. We may concede, too, that "the sale of capital results only in changing its form and like the mere issue of a stock dividend, makes the recipient no richer than before." But some changes in form are realizations and others are not. The stock dividend is held not income because not an adequate realization. A cash dividend[12] or a dividend in property is

[4] (1872) 15 Wall. (82 U. S.) 63. [5] *Ibid.* p. 65.
[6] (1918) 247 U. S. 221, 38 Sup. Ct. 537. [7] *Supra,* footnote 4.
[8] *Supra* footnote 6, p. 230.
[9] Cases cited in footnote 2, *supra.* See *Hays* v. *Gauley Mountain Coal Co.,* at p. 192, where Mr. Justice Pitney distinguishes *Gray* v. *Darlington* because of the difference between the Act of 1867 and the Act of 1909.
[10] *Supra,* footnote 4. [11] Holmes, *Collected Legal Papers* (1920) p. 173.
[12] *Lynch* v. *Hornby* (1918) 247 U. S. 339, 38 Sup. Ct. 543.

a realization,[13] though they too are merely changes in form which make the recipient no richer than before. [14] Mere realization of gain never makes one richer. It only makes pre-existing gain more certain and more available. A lawyer who has worked ten years for a fee and reduced his claim to a judgment against a solvent client may count that judgment in his assets when he asks for credit. When the judgment is paid, he is no richer than he was the moment before; but by the payment his gain is realized and becomes income. The requisite of realization is not that the realization itself shall be a gain but that it shall extract a gain from that in which it heretofore inhered. Since gain is usually gradual and realization usually instantaneous, there would be little income from any source under a doctrine that the gain must not precede the realization. The only difference between gain realized by sale and gains realized by rents, interest, and dividends, is that usually the latter accrue within or near the year in which they are realized. Yet it would not be contended that a tenant five years in arrears does not add to his landlord's income when he finally pays up. The duration of the period during which the gain was accruing is important only because the progressive surtax rates are based on the realization within the given annual period, except when books are kept on an accrual basis. This undoubtedly is a hardship and may be regarded as inequitable. But it does not follow that it is unconstitutional. The Sixteenth Amendment is not by its terms limited to annual income. An income tax may be retroactive as to realization as well as gain.[15] The complaint against the taxation of gains from sale of capital is properly addressed only to the question of rates and not to the question of what constitutes income as distinct from capital. Of constitutional relief from oppressive rates the taxpayer can have little hope.[16] If the fruit of years of toil may be taxed as income for the year in which it is picked, the Supreme Court will hardly venture to hold that the cashing in of an unearned increment is not income, when it has so recently given a distinct declaration to the contrary. T. R. P.

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[13] *Peabody* v. *Eisner* (1918) 247 U. S. 347, 38 Sup. Ct. 546.

[14] In the two preceding cases of actual transfer of assets from the corporation to the stockholder, the court did not inquire into the circumstances under which the stockholder acquired his stock so as to discern whether the transfer represented any actual gain to him. The court held also that the dividends were income under the Sixteenth Amendment although they were the fruit of corporate profits that accumulated before the Amendment took effect. This shows that there may be income under the Sixteenth Amendment although the conversion or realization is not itself a gainful process. The Stock Dividend Decision, therefore, must rest on the absence of any adequate realization, and what it says about making the stockholder no richer cannot be taken to mean that the realization of gain is not income when the gain had accrued before the realization. In so far as Judge Thomas finds any comfort whatever in the Stock Dividend Decision, he is completely deluded.

The principal case raises another problem which the sweeping decision avoids. The stock sold was worth in 1913 considerably less than had been paid for it some years prior. The seller was taxed on the advance from 1913 which was in excess of his actual profit. If the statute excludes gain accrued before 1913, may it exclude loss accrued before 1913 but not realized? The hardship is apparent, and it would seem decent for Congress to take the valuation of 1913 or the original cost, whichever is higher, as the basis from which to reckon the profit. Yet, after all, the seller had made since 1913 all his gain since then, and it is hard to find any constitutional objection to modes of assessment that start with the situation when the power to impose an unapportioned income tax first arose. This is even less cruel than to tax as income the dividends produced after 1913 by a corporate surplus acquired earlier, particularly in the cases where the stockholder bought his stock at a price influenced by the existing corporate surplus.

[15] *Stockdale* v. *Insurance Co.* (87 U. S. 1874) 20 Wall. 323; *Brushaber* v. *Union Pacific R. R.* (1916) 240 U. S. 1, 20, 36 Sup. Ct. 236.

[16] See *Billings* v. *United States* (1914) 232 U. S. 261, 282-283, 34 Sup. Ct. 421, and *Brushaber* v. *Union Pacific R. R.* (1916) 240 U. S. 1, 24, 36 Sup. Ct. 236.